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What's Really Wrong With The Accounting Profession?

Keynote Speech

A. A. Sommer, Jr.

Chairman, Public Oversight Board

It is a great pleasure and honor for me to be able to speak at this distinguished and respected symposium which has gained such stature within the accounting profession and which, over the years, has provided a means for exploring the important issues confronting the accounting profession. The topics on the program this year evidence the continuing commitment of the sponsors of this program to the discussion of themes which are of tremendous practical, as well as theoretical, importance to the profession.

When I was asked for a title for my remarks, I thought for a few seconds and suggested, "What's Really Wrong with the Accounting Profession?" Only as I reflected on that title later did I fully realize that it might raise expectations different from what I intended to say. It is not my intention to "dump" on the profession or the fine people who practice accounting. What I am really going to talk about is how the financial reporting process may be strengthened and the dangers to professionalism I see in the present climate mitigated. For the most part I won't cover the ground the POB did in its March, 1993 Report.

Strengthening Financial Reporting

I am a fervent believer in disclosure as the foundation of our securities regulatory system in this country. At the core of meaningful disclosure is financial information - reliable, timely, relevant, useful and understandable financial information. That truism, long-accepted, was reiterated in the 1973 Report of the Study Group on the Objectives of Financial Statements prepared under the aegis of Robert M. Trueblood, a distinguished partner of one of the predecessor firms of the co-sponsor of this conference. The importance of communicating that information was underscored by the Long-Range Objectives Committee of the AICPA some years ago:

A satisfactory system for communicating financial and other economic data is an essential condition for the accumulations of capital from widespread sources in single enterprises - i.e. for a successful industrial economy. Persons who have an interest in resources are in varying degrees of remoteness from them and from the factors affecting them. The greater this remoteness, the greater the need for communication of data... In fact, without assurance of reliable economic data, the remote investor or creditor probably would not supply capital to the enterprise... (Emphasis in the original)

The auditor's role in the "reliability, timeliness, relevance, usefulness and understandability" formula is principally the assurance of reliability and those assurances enhance the usefulness of the information. Along with the information itself, the extent to which the information may be relied upon must be effectively communicated. I would say that while the quantum and quality of information about issuers that is being communicated to shareholders and investors have steadily improved (witness the SEC's recent rule changes concerning disclosure with respect to executive compensation), there has been scant improvement in communicating the extent to which the information is reliable.

In 1978 the AICPA-organized Commission on Auditors' Responsibilities published its report. A significant part of that report discussed the contents of the auditor's report on financial statements. In the course of its discussion of this subject it quoted the report of the auditors of the United States Steel Corporation in 1903. It is informative, detailed and provides an interesting contrast to the sterile and boiler-plate style which has prevailed since at least 1933 in various iterations.

The Cohen Commission (the popular appellation for the Commission on Auditors' Responsibilities) included in its report an illustration of what it perceived to be a desirable form of auditor's report. It took up more than an eight-and-a-half by eleven page in the report (and the type was relatively small) and included eight meaty and informative paragraphs. The Auditing Standards Board, in response to the Report, undertook revisions of the standard report. What was the result? Instead of two stereotyped paragraphs, we now have three stereotyped paragraphs that *nobody, but nobody*, reads or heeds.

Amid all the consternation (justified, I might add) within the profession about auditors' exposure to litigation, I would suggest that means at hand to significantly reduce that exposure are being ignored. Let me elaborate.

Every line in a balance sheet, income statement, cash flow statement looks like every other line. "Cash" looks just like "inventory", looks just like "property, plant and equipment" which may include huge amounts of "soft costs" that have been included on that line in the expectation of future benefits that are by no means assured of realization. And to the laymen, including some sophisticated users of information, the auditor's opinion is as much an assurance of the reliability of any line as it is of the "Cash" line.

I have on occasion only half-facetiously suggested that financial statements should be prepared in varying shades of grey. Dark, dark ink and bold typeface should be used for cash. Inventories should be slightly lighter; capitalized costs uncertain of realization should be, not in disappearing ink, but in very light ink and type. And then the auditor's opinion should explain the significance in the degrees of shading.

I would suggest to you that some of the woes of the accounting profession flowing from the savings and loan debacle in this country might have been avoided if the auditor had communicated the limits of extent to which people could rely on the financial statements of the savings and loans. How about this as a paragraph in the opinion of an auditor of a savings and loan:

\$_____ of the assets of the company (____%) consist of loans secured by mortgages with no provision for recourse against the borrower. Thus the company's ability to realize on these assets depends upon the ability of the borrower to make timely payments and the continued value of the underlying asset. While the documents in the files of the company indicate that the value of the real estate underlying the mortgages is presently in excess of the amount of the loans and that the cash flows from the properties (with respect to loans in the amount of \$_____ cash flows have not commenced) will be sufficient to assure orderly amortization of the debt, there is no assurance that these conditions will continue.

There is presently developing in securities law a doctrine called "bespeaks caution." In the words of one court,

...The essence of the [bespeaks caution] doctrine is that where an offering statement, such as a prospectus, accompanies statements of its future forecasts, projections and expectations with *adequate cautionary language*, those statements are not actionable as securities fraud (Emphasis supplied).

While this is a relatively new doctrine and one that does not yet enjoy the imprimatur of the Supreme Court (although it has been approved by the Second Circuit

Court of Appeals, the preeminent commercial court in the country), it should provoke a renewed consideration by the accounting profession of how, through effective communications, it can enjoy the benefits of “bespeaks caution.” This would entail a careful delineation of the uncertainties inherent in financial statements, a statement tailored to the issuer’s statements, not new boilerplate.

The POB in its report urged the Auditing Standards Board to revise the auditor’s standard report to make the prospective nature of certain accounting estimates clear, including a caveat that the estimated results may not be achieved. This communication should not be written as a defensive retrenchment by the auditing profession, but rather as a more realistic and reasonable explanation of the limitation of assurance that can be provided on certain accounting estimates.

Happily the Auditing Standards Board’s Auditing Soft Information Task Force has undertaken consideration of this proposal. A significant step toward better communication with regard to these matters has been the approval recently by the Accounting Standards Executive Committee of its slightly modified exposure draft on risks and uncertainties. The POB in its report last year strongly advocated adoption of this statement and we are most hopeful that the FASB will now approve it.[†] While the application of the statement is somewhat narrower than I would like, I believe this statement will give a powerful tool to accountants in compelling client disclosure of important risks and uncertainties related to the business. I would hazard a guess that had this statement been in effect ten years ago some of the problems associated with the audits of savings and loans could have been avoided.

The preliminary report of the AICPA Special Committee’s Study of the Information Needs of Today’s Users of Financial Reporting (the Jenkins Committee) indicates that “Users want companies to disclose information about the estimates and assumptions used to determine material assets and liability amounts.”

I am informed that this desire of users will probably be reflected in one or more recommendations of that Committee. The problem then will be to develop the necessary consensus to implement the recommendation. That is the toughest task. Congressman Edward Markey of Massachusetts has recently asked the General Accounting Office to review the various reports which have been prepared by accounting bodies since 1975 and report on the extent to which the recommendations in them have been acted upon. While in many respects the profession has responded earnestly, I fear this study may reveal that other important recommendations have been ignored or only partially implemented. I will cite as Exhibit A the matter I referred to earlier, the failure of the Auditing Standards Board to come to grip adequately with the recommendation of the Cohen Commission that the auditor’s report be made more meaningful.

I think it is imperative that top management assume greater responsibility for the internal controls and the internal auditing function of their companies, and that the external auditors assume greater responsibility for those controls and internal audit functions. I understand that the Committee of Sponsoring Organizations (COSO) of the Treadway Commission and the General Accounting Office have reached agreement on what a management statement with respect to internal controls should embrace. This a great step forward, and I hope it will be followed by action from the SEC *mandating*, one, management reporting on internal controls in accordance with the COSO Report, *Internal Control - Integrated Framework*, and, two, external auditor reporting on the validity of management’s representations.

[†] It has approved the Statement of Position.

In arguing against any requirement that the external auditor report on internal controls, Robert A. Bowman, executive vice president and chief financial officer of ITT Corporation and the spokesman for the Financial Executives Institute, at the hearing held by Senator Dodd of Connecticut on private litigation under the securities laws in July of last year said,

Any public accounting firm, any firm, that suggests to you and this committee that it does not understand a company's internal controls and they still sign that letter of opinion we think is engaging in sophistry.

We would not expect any public accounting firm to sign its name without understanding *fully and completely* the internal controls of a company, large or small. (Emphasis added)

I respectfully suggest that if Mr. Bowman is correct, then there should be no problem - or significant added expense - in requiring auditors to opine on management's representations with respect to the company's internal controls. I would therefore reiterate the recommendation which the Public Oversight Board made in its March 5, 1993 report: a company's auditors should be required to report on the representations of management with respect to their company's internal controls. The SEC has indicated an unwillingness to mandate this. I would urge that some responsible large companies voluntarily move in this direction and pioneer a healthy and needed additional safeguard for investors - and themselves.

Dangers to Professionalism

The second problem I perceive with the accounting profession is one related to professionalism and emanates from a society-wide circumstance. Competition has always been present in the accounting profession, but I suspect it has never been as intense, as tough, *as dangerous*, as it is now.

More intense competition has infected every corner of our society; my own profession is experiencing a measure of competition it has never before seen. Where the intensification of competition originated is not clear. Some ascribe it to the onset of more international competition which compelled enterprises in this country to sharpen their claws; others say it is an inevitable progression in a market economy.

In the professions, I think there may be some unique circumstances. For one thing, I think professionals have become more concerned with their incomes than with their status as professionals. Sol Linowitz, a distinguished lawyer and former government official, in his recent book, *The Betrayed Profession*, which deals with events in the legal profession, quotes a young lawyer in a mid-size law firm: "The practice of law changed forever when lawyers decided they should be making as much money as their clients." That quote, I think, is equally applicable to accountants.

When the increasing concern with income combines with the increased transparency with respect to economic information concerning firms and their members, there is bound to be increased pressure on the management of firms to maximize the returns to their partners lest they lose them to seemingly more prosperous competitors or other kinds of occupations which can use their skills.

Another factor, reenforcing these competitive forces, has been the determination of the federal regulatory authorities and the courts to regard the professions as no different from other ways of making a living. Thus, measures and rules once thought to be safeguards against unethical and unprofessional conduct were thrown out without any discerning examination of whether professions should be considered just other businesses. It was scant consolation when I heard a sitting FTC Commissioner at a bar meeting suggest that the FTC had grievously erred when it went down that road.

The more intense the competition, whatever the source of that intensity, the more pressure there is on law compliance, on ethics, and on *judgment*. We read daily of businessmen who cross the line between legal and illegal. They don't make that crossing because they are evil or malicious or indifferent; they often do it because they feel they must if they are to compete effectively and meet the expectations of their superiors. How much more fragile and elastic are the boundaries of ethics. And how much more easily infected is professional judgment.

I have often posited the case of the rising young partner in a major firm who manages an office of his or her firm in, to bring it close to home, let's say Kansas City. He is also the engagement partner of the office's largest client which accounts for about a quarter of the revenues of the office.

The financial statements prepared by the client classify as restructuring costs certain items which the young partner believes should be recurring period costs. He expresses this opinion to the chief financial officer, who challenges him to point to the accounting literature which compels that the costs be classified as recurring period costs. The young partner says he cannot point to such authority, but in his professional judgment the proper treatment is to classify the items as recurring period costs. The CFO mentions that he casually discussed this at a cocktail party with a partner of a competing firm, one which young partner knows has been lusting after the business, who indicated he agreed with the CFO as to the proper accounting treatment.

The young partner's dilemma is clear. If he loses the client a substantial number of staff in the office will, at least for some time, be underutilized. He *hopes* the management of the firm will realize that he has lost the client on a matter of principle and will not penalize him in his career, and hopes, in fact, they will back him. But what about next year if the staff is still underutilized and no new clients have filled the void? And the year after, and the one after that? It is not difficult to empathize with the agony of that young partner.

One would hope that if he acquiesced in the insistence of his client and opined on the financial statements as prepared by the client that the concurring partner would block approval, or that one or the other would consult on the issue. If the end of the process is that the client walks because of either the engagement partner taking a tough stand, or the concurring partner or consulting partner doing so, the problem confronting the young partner is the same: how to fill the void?

I would hope that in this sort of situation the top management of the firm would set a "tone" by assuring that insistence on good accounting and financial reporting does not *ever* penalize a partner. I was told once of the head of a major firm who, at a partner's meeting, singled out a partner who had lost a major client because of an accounting disagreement and hailed him as the "partner of the year."

There is no question that auditors today are more willing than before to take tough stands even at the risk of losing clients, and increasingly they state forthrightly the reasons for their departure in connection with the client's Form 8-K. But I fear there are still a troubling number of occasions when my scenario is a real one and an undesirable accounting practice not clearly contrary to an articulated principle is accepted by the auditor. The number of such instances can only be reduced if it is made clear by the top management of firms that not only are those who generate and perpetuate business amply rewarded, but so are those who on reasonable grounds refuse to go along with corner-cutting clients.

And I would urge that a firm which is approached to take on a client which has deserted another auditor because of an auditing or accounting disagreement consider carefully whether it really wants to reenforce the belief that exists in many quarters

that accounting principles and auditing standards are “for sale.” Accounting is not and probably never will be exact and reducible to formulas so precise that there can not be disagreement among honest accountants. But I would suggest that the case for acquiescing in a potential client’s wishes who is changing auditors because of disagreement should be an overwhelmingly compelling one before the auditor accepts the client.

Audit committees, which have been a particular matter of interest and concern to the POB and to me personally, are important both from the standpoint of sound financial reporting and professionalism. I believe their potential for assuring honest financial reporting has been little realized and I believe the realization of that potential can only be accomplished by auditors. In undertaking that task I think auditors may not only contribute to sound corporate governance, but also reduce their exposure to liability. It is not enough for auditors to publish booklets on audit committees, excellent as those pamphlets generally are. In my experience, few audit committee members read them and study them and conform their conduct to the advice contained in them.

I have urged in the past, and I urge again, that the auditor of every publicly held company with an audit committee arrange to meet with the audit committee for two or three hours to outline how an audit committee should function, the duties it should assume, the concerns it should have. The superb report prepared by Price Waterhouse for the Institute of Internal Auditors Research Foundation, *Improving Audit Committees: What Works Best*, would be an excellent guide for such a presentation. Also helpful would be the matrices in Appendix E of the POB’s Report, *In the Public Interest*, and in the Price Waterhouse report, both of which are based on the Treadway Commission Report. These matrices provide the means for an audit committee to do a searching analysis of its practices and compare them to the excellent recommendations of that Commission. But I am convinced that without the initiative of the external auditors that sort of self-analysis simply will not occur. If audit committees did what they should, they would be immeasurably better able to assess the fairness of the presentation proposed by management, monitor disagreements between management and the auditors, and provide an additional level of assurance that management is honest with its auditors.

Let me close by remarking upon the response to the POB’s Report, *In the Public Interest*. Soon after its publication, the AICPA and the “Big Six” endorsed all of its recommendations. This has been most gratifying to the members of the Board. Even more gratifying is the alacrity with which the SEC Practice Section has undertaken initiatives to strengthen the ability of auditors to detect fraud (a consequence of an audit expected by the overwhelming number of users of financial statements) and to use the information secured in the course of inquiries by the Quality Control Inquiry Committee to warn the profession of pitfalls they should avoid.

Again, let me repeat how privileged I feel to have had this opportunity to meet with all of you and express a few thoughts of someone who, while closely associated with the accounting profession in a number of capacities for many years, is still just a lawyer and, from your viewpoint, a layman.

References

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